DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0153
Indiana Corporate Income Tax
For 1995 through 2000

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ISSUE

I. Lease/Sales Transactions – Gross Income Tax.

Authority: IC 6-2.1-1-2(a); IC 6-2.1-1-2(b); IC 6-2.1-2-2; IC 6-2.1-2-2(a); IC 6-2.1-2-2(a)(2); Enterprise Leasing v. Indiana Dept. of Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); Comdisco, Inc. v. Indiana Dept. of Revenue, No. 49T10-9903-TA-19, 2002 Ind. Tax LEXIS 93 (Ind. Tax Dec. 18, 2002); 45 IAC 1.1-1-3(a), (b).

Taxpayer argues that the Department of Revenue erred when it determined that money received in the form of lease payments and money received from the sale of office equipment to Indiana customers was subject to gross income tax.

II. Ten-Percent Negligence Penalty – Tax Administration.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the Department should exercise its discretionary authority to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of leasing and selling tangible personal property. Taxpayer typically leases items of office equipment such as copiers, fax machines, and phone systems. Taxpayer leases or sells office equipment to Indiana customers. Taxpayer finances the sale of office equipment to Indiana customers. Taxpayer sells used office equipment to Indiana customers.

The Department of Revenue (Department) conducted an audit review of taxpayer's business records and found that taxpayer should have been paying Indiana Gross Income Tax (GIT) on the money received in the form of lease payments and money received from the sale of office equipment to Indiana customers. Accordingly, the Department assessed GIT for 1995 through 2000. Taxpayer disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative explained the basis for the protest. This Letter of Findings results.

DISCUSSION

I. Lease/Sales Transactions – Gross Income Tax.

The Department found that taxpayer leased equipment to Indiana customers and concluded that the lease payments were subject to GIT. The audit report stated that, "Most of [taxpayer's] leases are true leases where the property is owned by them, depreciated by them, leased through them or one of their vendors, credit approved by them, and they retain title at the conclusion of the lease." In most cases, after the lease is concluded, the lessee has the right to purchase the item of equipment, but if the lessee decides not to buy the equipment, taxpayer "sells the product to someone else through his vendor in the state of Indiana or through [taxpayer's out-of-state office]."

In addition, the audit found that taxpayer had entered into "financing leases" which the audit described as "similar to an installment contract." Again, the audit found that taxpayer did not "subject any of these sales to the gross income tax." The audit concluded that the money taxpayer received from these sales was subject to GIT and assessed the tax accordingly.

According to taxpayer, its leasing business is conducted as follows:

A potential customer – interested in purchasing or leasing an item of office equipment – contacts an Indiana vendor. Customer decides on the specific item it wants to acquire. Vendor and customer agree on the cost of the equipment. Based upon preexisting "unwritten agreements" between taxpayer and each individual vendor, vendor provides customer a variety of lease options to customer including, presumably, the option of leasing the equipment from taxpayer. If customer decides to do business with taxpayer – and not one of taxpayer's competitors – vendor provides customer with a variety of lease options available through taxpayer. Among other lease or sales options, taxpayer provides a "non-cancelable lease, without a stated purchase option," a "90-day same as cash program," a "standard program with a 90 day deferment," and a "municipal program." In any case, it is the vendor's representative who acts as the intermediary soliciting the customer's lease or sales business on behalf of the taxpayer and describing taxpayer's sale or lease options to the Indiana customer.

After customer has decided to do business with taxpayer and after customer has decided which of taxpayer's lease/sales programs it wishes to choose, vendor supplies customer with the appropriate, blank paperwork; customer fills out a credit application and a "pre-drafted" lease/sales agreement. After customer fills out this paperwork, vendor faxes a copy to taxpayer. Upon receipt at taxpayer's out-of-state location, taxpayer either accepts or declines the proposed agreement.

If the agreement is accepted, vendor delivers the equipment from vendor's own stock to customer. If the delivered equipment is acceptable, customer accepts delivery, and taxpayer pays vendor for the cost of the equipment.

Taxpayer now owns the item of equipment because taxpayer bought the equipment from vendor. Customer thereafter pays money to taxpayer for the privilege of using that equipment at the customer's location or customer pays taxpayer in order to eventually acquire full ownership of the equipment.

Taxpayer maintains that its income from Indiana customers is not subject to gross income tax because it does not have an Indiana business situs.

Taxpayer states that it "has no employees or payroll located within the state of Indiana, nor any employees or agents that spend time in Indiana. [Taxpayer] does not have a sales-force that solicits business in Indiana and does not direct advertising into the Indiana market. All office functions are located [out-of-state]. [Taxpayer] has unwritten agreements with vendors all over the country for them to recommend [taxpayer] as the loan provider for the equipment."

Indiana imposed a tax, known as the "gross income tax," on the taxable gross income of taxpayer who is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2. "Gross income" is defined to include "all the gross receipts a taxpayer receives . . . from the sale, transfer, or exchange of property, real or personal, tangible or intangible." IC 6-2.1-1-2(a).

There is no apparent dispute that the money taxpayer received constitutes "gross income" under IC 6-2.1-1-2(a). The issue is whether the money was "derived from activities or businesses or any other sources within Indiana" pursuant to IC 6-2.1-2-2(a)(2).

In deciding whether the money taxpayer earned was derived from sources within Indiana, "[T]he Court must (1) isolate the transaction giving rise to the income ('the critical transaction'), (2) determine whether the [taxpayer has] a physical presence in, or significant business activities within the taxing state ('business situs'), and (3) determine whether the Indiana activities are related to the critical transaction and are more than minimal, not remote or incidental to the transaction ('tax situs')." Enterprise Leasing v. Indiana Dept. of State Revenue, 779 N.E.2d 1284, 1290 (Ind. Tax Ct. 2002).

A. Critical Transaction.

"The critical transaction is defined as the particular activity that gives rise to the gross income in dispute." Id. In this case, the critical transactions are the various lease and sales agreements entered into between Indiana customers and out-of-state taxpayer.

B. Business Situs.

45 IAC 1.1-1-3(a), (b) provides that, "A 'business situs' arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile. A taxpayer may establish a business situs in many ways, including, but not limited to . . . . [o]wnership, leasing, rental, or other business activity connected with income-producing property . . . ."

Taxpayer has established an Indiana business situs because it leases business equipment to Indiana customers (true leases); taxpayer has established an Indiana business situs because it finances the sale of office equipment to its Indiana customers (financing leases); taxpayer has established an Indiana business situs because it sells used office equipment – following conclusion of a true lease – to Indiana customers who are in the market for purchasing these items. In effect, taxpayer has established an Indiana business situs because it owns office equipment – located within Indiana –

from which it derives rental income or from which derives income when it sells the equipment. These activities plainly fall within the purview of 45 IAC 1.1-1-3(a), (b) because taxpayer owns income-producing office equipment located within Indiana. Taxpayer has a "property right" in a "business or investment activity away from [taxpayer's] domicile." Id. The analysis is straightforward. Taxpayer has an Indiana business situs because taxpayer leases or finances the sale of new office equipment to Indiana customers, and taxpayer sells used office equipment to Indiana customers.

C. Tax Situs.

In Indiana, "[A] 'business situs' . . . is insufficient by itself to impose tax on a nonresident's income." Enterprise Leasing, 779 N.E.2d at 1291-92. A taxpayer may have more than one "business situs." Id. at 1292. "This is especially true for tangible property, especially mobile property such as . . . cars and trucks . . . ." Id.

In order to establish whether taxpayer has an Indiana tax situs, "[The] Court must examine whether the Petitioners' Indiana activities are related to the critical transaction and are more than minimal, not remote or incidental to the total transaction." Id. In its argument, taxpayer concludes that its leasing and financing business is analogous to that of the petitioner-taxpayers in Enterprise Leasing, 779 N.E.2d 1284. In that case, the Tax Court found that an out-of-state company did not receive Indiana source income when it rented Indiana-titled cars to its customers; therefore, the court concluded that petitioners' rental income was "not subject to Indiana's gross income tax." Id. at 1292. The court found that that money received from renting Indiana-titled cars was not Indiana source income because it was not the petitioners who decided to register and operate the cars within the state. Id. at 1291. Rather, it was the decision of the individual customers to register and operate the cars in Indiana. Id. The court found that the petitioners' activities in sending the cars to its customers "did not rise to the level of 'active participation' in the 'ownership, leasing, or rental' of property in Indiana." Id. The court determined that the "critical transaction" related to the leasing of the cars occurred at the petitioners' out-of-state location. Id. at 1290. Therefore, because the petitioners' activities within the state were "not more than minimal" and were "remote and incidental to the lease transaction from which [petitioners'] income [was] derived," and because *the critical transaction occurred outside the state*, the petitioners did not have an Indiana "tax situs." Id. at 1292. (*Emphasis added*). The court concluded that the petitioners' lease income was not "derived from sources within Indiana" and was not subject to the state's gross income tax. Id.

In addition, taxpayer cites to Comdisco, Inc. v. Indiana Dept. of Revenue, No. 49T10-9903-TA-19, 2002 Ind. Tax LEXIS 93 (Ind. Tax Dec. 18, 2002), in which the court found that income received from leasing "high technology and medical equipment" to customers within Indiana was not subject to gross income tax. Id. at *5. In Comdisco the court found that the petitioner/lessors only Indiana activity was "ownership of high technology equipment that [was] located pursuant to the lessees' direction." Comdisco, 2002 Ind. Tax LEXIS 93 at *22.

The Department is unable to agree that the decisions in either Enterprise or Comdisco are dispositive of the question of whether the taxpayer's receipts earned from the rental or sale of office equipment – brokered by representatives acting on behalf of the taxpayer – is subject to the gross income tax. In both Enterprise and Comdisco the fact that the tangible personal property happened to be located within Indiana was unrelated to the "critical transaction" which formed the basis for the petitioners' income. In taxpayer's situation, the rental and sales income is derived from immobile property located within this state and the "critical transaction[s]" – on which the taxpayer's income is predicated – were solicited and executed within the state.

The critical transactions consist of the agreements brokered between the customer and the vendors' representative. The vendors' representative – acting at the behest of taxpayer – solicits business on behalf of taxpayer from Indiana customers. When one of the vendors' representatives offers a prospective Indiana customer the opportunity to purchase or lease office equipment, that offer is made in Indiana to an Indiana customer; when one of the vendors' representatives solicits business on behalf of the taxpayer, negotiates the sales or lease cost on behalf of the taxpayer, and solicits credit information from the potential customer, those negotiations and solicitations occur at the Indiana location; when the paperwork is completed and customer finally accepts and signs the agreement, the customer does so while seated at a desk located in Indiana; when the Indiana vendor eventually delivers the office equipment – the "object" of each particular critical transaction – the vendor does so to a site specified in the lease or sale agreement.

Taxpayer's transactions are not analogous to the lease agreements in Enterprise. In that case, the court found that because the leased automobiles had little or no connection with the state of Indiana, the petitioner-lessor did not acquire an Indiana tax situs. Instead the leased automobiles were cast adrift into a stream of commerce by means of a "critical transaction" which occurred entirely outside the state. In taxpayer's own leasing and financing business, the critical transactions take place in this state and are facilitated by both the Indiana employees and the Indiana surrogate/agents acting on behalf of taxpayer. Unlike the automobiles in Enterprise, taxpayer's office equipment – the source of taxpayer's income – is determinedly fixed within this state.

Taxpayer has acquired both a business and tax situs within Indiana. Taxpayer earns money from Indiana customers attributable to transactions which – although given a final stamp of approval at an out-of-state location – are solicited, negotiated, and accepted at an Indiana location. There is a direct and immediate connection between the "critical transactions" and the office equipment the location of which is specified in each of the relevant transactions. The sales and lease income attributable to these same critical transactions is subject to Indiana's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Ten-Percent Negligence Penalty – Tax Administration.

Taxpayer argues that its failure to report and pay gross income tax was not due to negligence and that the Department should exercise its discretion to abate the ten-percent negligence penalty.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer indicates that it relied on certain Tax Court decisions in deciding that it had no gross income tax exposure. Taxpayer believes that its facts "are nearly identical to those in the Indiana cases with presidential (sic) value . . . and therefore provide a reasonable basis for excluding [its] gross income for purposes of gross income tax."

As noted above, the Department disagrees with taxpayer's position that it was not subject to gross income tax. Nonetheless, the Department is willing to agree that failure to remit the tax was due to "reasonable cause and not due to willful neglect." IC 6-8.1-10-2.1(d).

FINDING

Taxpayer's protest is sustained.

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